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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 628

UNITED STATES OF AMERICA, PETITIONER

v.

MIDLAND-ROSS CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (R. 18–33) is reported at 214 F. Supp. 631. The opinion of the court of appeals (R. 35–36) is reported at 335 F. 2d 561.

JURISDICTION

The judgment of the court of appeals was entered on July 29, 1964 (R. 36). The petition for writ of certiorari was filed on October 26, 1964, and was granted on December 14, 1964 (R. 37). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the excess of the face amount of a note over the amount of money for which it was issued represents interest, making that portion of the proceeds of the lender's subsequent sale of the note which is attributable to the excess taxable as ordinary income rather than as capital gain.

STATUTES INVOLVED

The relevant statutes and regulations are set out in the Appendix, pp. 47–53, *infra*.

STATEMENT

At various times during 1952, 1953, and 1954, respondent advanced large sums of money to financial institutions in exchange for notes of those institutions. The notes, 13 in number, were usually in the face amount of $1,000,000 or $2,000,000 and in each case were payable in less than a year. The notes did not in terms provide for interest, but the amount advanced in exchange for the notes was determined by discounting the face amount at a rate agreed upon by the parties (usually between 2% and 2.5% on an annual basis). In each instance, respondent sold the note to a bank a few days before its maturity (R. 12–16). A typical transaction, as described in the stipulation, was the following (R. 13):

> On January 29, 1952, [respondent] paid $1,955,416.67 to the Commercial Investment Trust Company and received in return therefor a note of the Commercial Investment Trust Company in the face amount of $2,000,000, payable to the

> **bearer on December 15, 1952. Said note was not in registered form and contained no provision for the payment of interest. On December 4, 1952, [respondent] sold said note to the Union Bank of Commerce for price of $1,998,166.67, resulting in a gain to [respondent] of $42,750.**

Respondent's total gain on the sale of the 13 notes was $282,763. It reported the gain on its income tax returns for the 3 years as capital gain. The Commissioner determined that the excess of the face amount of the notes over the amount of money for which they were issued represented interest. Since the notes were all sold in the same taxable year in which they were acquired, and since the gain was attributable entirely to the maturing of the notes and the discount at which they were issued, he treated the entire gain realized on the sale of the notes as ordinary income in the nature of interest (R. 17). Respondent paid the resulting deficiencies in income and excess profits taxes and in due course brought this suit for refund (R. 12). The district court held the gains taxable only as capital gain (R. 18–33) and entered judgment for respondent in the amount of $192,463 plus interest from the date of overpayment (R. 34). The court of appeals affirmed in a brief *per curiam* opinion (R. 35–36).

SUMMARY OF ARGUMENT

If *A* gives *B* $100 for a note promising to pay in one year, $100 plus 6% interest, and if *A* sells the note eight months later for $104, it is conceded that

$4 of the proceeds of the sale, being attributable to the interest earned up to the date of the sale, would be taxable to *A* as ordinary income. The only question in this case is whether, under the 1939 Code, it makes a difference if the note promises to pay, not "$100 plus 6% interest," but simply "$106." The court below held that it does and that, if the note is cast in the latter form, the $4 gain is taxable only as capital gain. The First, Second, Third, Fifth and Ninth Circuits, the Court of Claims, and the Tax Court, disagreeing with the Sixth Circuit, all hold that the $4 is taxable as ordinary income in either case.

The expressions "$100 plus 6% interest for one year" and "$106" mean exactly the same thing; they are as identical as are the expressions "2 times 2" and "4". In either case, the borrower agrees to pay an additional $6 to the lender at the end of the year as compensation for the use of the $100 borrowed. Interest being but "compensation for the use or forebearance of money" (*Deputy* v. *DuPont,* 308 U.S. 488, 498), the $6 is interest in either case, and the maturing right to receive the promised amount is thus a maturing right to ordinary income the proceeds of the sale of which must be taxed as ordinary income.

Nor does the historical treatment of "original-issue discount," as the district court thought, require so illogical a distinction to be made. The earlier decision of the Sixth Circuit on which the court relied was based, not on a distinction between original-issue discount and stated interest, but on a reading of § 117(f)

of the 1939 Code as specifically directing that capital gains treatment be given to *all* amounts realized on retirement of debt obligations regardless of whether any part was interest (as the court acknowledged it in fact was). The ground of that decision has long since been repudiated, and it cannot now be read as establishing a distinction between the two forms of interest which the court itself denied.

The identity of original-issue discount and interest has long been recognized in every context in which the character of an item as "interest" is important. Under regulations in force since 1918 and the uniform decisions of both this Court and the lower courts, it is established that, to the borrower, the excess of the amount of money he must repay on maturity over the amount borrowed is but a cost of the use of borrowed money which, if he is on the accrual basis, he may accrue and deduct annually. Similarly, original-issue discount has long been treated as interest for purposes of the statutory exclusion of "interest" from State and municipal bonds. While there was initially some doubt how the exemption applied to amounts received from third parties, since 1932 it has been established that the portion of the proceeds of a sale of a State bond attributable to the discount at which the bond was issued is itself "interest" within the meaning of the exemption. Again, it has been established at least since 1925 that an accrual-basis lender who lends money on a discount basis (*e.g.*, a bank which loans $100 in exchange for the borrower's note in the amount of $106) must

accrue as income the portion of the discount earned each year. Finally, in 1941 Congress, regarding it as settled under existing law that the proceeds of a sale of an obligation issued at a discount must be allocated between the portion attributable to the discount (taxable as ordinary income) and the portion attributable to the underlying asset (accounted for as capital gain or loss), adopted special provisions to relieve holders of short-term government obligations of the burden of making such allocations—in circumstances in which they had little effect—and instead made the entire gain on disposition taxable as ordinary income.

Far from requiring that a distinction be made between logically indistinguishable things, the history thus shows that original-issue discount has for decades been regarded as but interest in another form—not only by the government but by Congress and the courts as well. The proceeds of a sale attributable to original-issue discount, like the proceeds attributable to stated interest, must therefore be taxed as ordinary income.

ARGUMENT

Introduction

On January 29, 1952, respondent paid $1,955,416 to the Commercial Investment Trust Company ("C.I.T.") in exchange for a note from C.I.T. promising to repay $2,000,000 (*i.e.*, the $1,955,416 borrowed plus an additional amount of $44,584) 321 days later. Eleven days before the note was due, respondent sold

the note to a bank for $1,998,166, thereby realizing a gain of $42,750. The question is whether the portion of the sale proceeds attributable to the almost fully accrued right to the additional $44,584 C.I.T. had agreed to pay in exchange for the use of the money—in effect, the $42,750 gain [1]—is to be taxed as ordinary income (the proceeds of a sale of a right to ordinary income) or as capital gain (the proceeds of a sale of a capital asset).

There is no dispute that the $42,750 would be taxable as ordinary income if the C.I.T. note had in form promised to pay, not the amount borrowed plus $44,584, but rather the amount borrowed "plus 2.6% interest." As the district court noted, respondent "fully admits that if these notes had borne interest at a stated rate, and if it had then sold such notes before maturity at an increase in price, the amount of such increase allocable to the proportion of the interest earned to the date of sale would have been regular income" (R. 20). The district court, whose opinion was in effect adopted by the court of appeals,

[1] The portion of the proceeds attributable to the accrued compensation is not technically the same thing as the "gain" on the sale, but on the facts of this case the difference was insignificant and was therefore ignored in determining the deficiencies.

In addition, since respondent is in fact an accrual-basis taxpayer, the transactions technically should have been accounted for on accrual principles. Since the notes were all sold in the same year they were acquired, however, the deficiencies were determined simply on the basis of the proceeds of the sales—in effect, because it was simpler and made no significant difference, treating respondent as though it were on the cash basis.

also agreed that that proposition "cannot be questioned" (R. 30), and it is in any event fully and firmly established by the decisions both of the court below and of other courts.[2] It is equally unchallenged that an accrual-basis taxpayer holding such a note beyond the end of his taxable year would have to accrue and report as income the interest earned on the note during the year.[3] The sole question, therefore, is whether it makes a difference for tax purposes whether the *quid pro quo* promised to be paid in exchange for the use of money is stated in the note as a percentage rate of "interest" or is stated as a part of a fixed sum of money not otherwise characterized.

The court below held that it makes all the difference and that the proceeds of a sale of a right to be paid a fixed sum as compensation for a loan of money is taxable only as capital gain, notwithstanding that the proceeds of a sale of a right to be paid the same amount, expressed as a rate of "interest," would be taxed as ordinary income. The First, Second, Third, Fifth, and Ninth Circuits, the Court of Claims, and the Tax Court, on the other hand, expressly reject the distinction and hold that the proceeds are taxable

[2] *Jaglom* v. *Commissioner*, 303 F. 2d 847 (C.A. 2); *Fisher* v. *Commissioner*, 209 F. 2d 513 (C.A. 6), certiorari denied, 347 U.S. 1014; *United States* v. *Langston*, 308 F. 2d 729 (C.A. 5); *First Kentucky Co.* v. *Gray*, 309 F. 2d 845 (C.A. 6); *Arnfeld* v. *United States*, 163 F. Supp. 865 (Ct. Cls.); cf. *Commissioner* v. *Phillips*, 275 F. 2d 33 (C.A. 4).

[3] See *Commissioner* v. *Morgan*, 272 F. 2d 936 (C.A. 9); *Dixon* v. *United States*, 333 F. 2d 1016 (C.A. 2), pending on certiorari, No. 486; *Oregon Pulp & Paper Co.* v. *Commissioner*, 34 T.C. 624; cf. Treas. Regs. 118, § 39.117(a)-1(d).

as ordinary income in either case.[4] For the future, the question has been largely resolved by § 1232 of the Internal Revenue Code of 1954, which expressly provides that any gain on the sale of corporate or governmental obligations issued at a discount will be treated as ordinary income to the extent of the original-issue discount. Because of the limitations on the scope of § 1232, however, the question of the proper treatment of such notes under the prior law remains of continuing importance.[5] Accordingly, to resolve the admitted conflict between the Sixth Circuit and the other courts as to the proper result under the 1939 Code, we acquiesced in the taxpayer's petition for certiorari in the companion case (*Dixon* v. *United States*, No. 486) and filed a petition on behalf of the United States in this case.

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[4] *Real Estate Investment Trust of America* v. *Commissioner*, 334 F. 2d 986 (C.A. 1), pending on petition for certiorari (No. 620); *Dixon* v. *United States*, 333 F. 2d 1016 (C.A. 2), pending on certiorari (No. 486); *Rosen* v. *United States*, 288 F. 2d 658 (C.A. 3); *United States* v. *Harrison*, 304 F. 2d 835 (C.A. 5), certiorari denied, 372 U.S. 934; *Commissioner* v. *Morgan*, 272 F. 2d 936 (C.A. 9); *Pattiz* v. *United States*, 311 F. 2d 947 (Ct. Cl.); *Schwartz* v. *Commissioner*, 40 T.C. 191. See also *Leavin* v. *Commissioner*, 37 T.C. 766; *Gibbons* v. *Commissioner*, 37 T.C. 569; *Nesler* v. *United States* (N.D. Iowa), decided December 19, 1963 (13 A.F.T.R. 2d 588); *Oglansky* v. *Commissioner*, decided January 23, 1963 (P-H Tax Ct. Mem. Dec., ¶ 63,018).

[5] Section 1232 does not apply to obligations issued before 1955 or to any obligations of individuals, nor does it in terms prescribe how original-issue discount should be treated under the accrual method of accounting. See our brief in response to the petition for certiorari in *Dixon* v. *United States*, No. 486, pp. 8–10.

We will first show that the distinction made by the court below is indefensible in principle and could not be sustained even if it were of long standing. We will then show, contrary to the assertion of the court below, that the recent decisions of the other courts uniformly rejecting its view, far from effecting an abrupt "change" in the law, are fully supported by the historical treatment of original-issue discount.

I

AN AMOUNT AGREED TO BE PAID BY A BORROWER TO A LENDER IN EXCHANGE FOR THE USE OF MONEY IS INTEREST FOR TAX PURPOSES REGARDLESS OF WHETHER IT IS STATED AS AN ABSOLUTE AMOUNT OF MONEY OR AS A PERCENTAGE RATE OF "INTEREST"

1. The decision below rests upon a difference of words having no substantive consequences. If *A* agrees to lend *B* $100 for a year and *B* in exchange agrees to pay *A* $6 extra at the end of the year, there are perhaps five basic variations in the wording that might be used to express *B's* obligation in a note. The note might provide that on the due date *B* will pay *A*:

(1) $100 plus 6% interest;
(2) $100 plus 6%;
(3) $100 plus $6 interest;
(4) $100 plus $6; or
(5) $106.

If *A* should sell the note for $104 after holding it for 8 months, the court below would hold that the $4 gain was ordinary income if the first form of expression

was used[6] but capital gain if the last form was used. What it would hold in the intermediate cases is less certain, since it is unclear precisely what it regards as the key to the different treatment: use of the word "interest" (in which event only 1 and 3 would yield ordinary income); expression of the consideration as a percentage (1 and 2); use of *either* the word "interest" or a percentage computation (1–3); or any form in which the consideration is separately stated (1–4). We note the ambiguity only because it demonstrates how tenuous the distinction is even as a matter of words. As a matter of substance, we need not dwell on the possible variants, for the short answer is that all the forms of expression mean exactly the same thing.

If the payment is made when due, it is self-evident that there is no difference between a note promising to pay "$100 plus 6% interest" a year hence and a note promising to pay "$106" on the same date. In neither case are periodic payments made and in both cases the identical amount is paid on the due date. Nor does the different form of expression in itself have any significance for other purposes, since prepayment and default penalties typically are (and in any event may be) provided for entirely separately—often with rates of interest wholly different from that applicable to the prescribed payments. Thus the basic rate of interest stated in a note is nothing

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[6] *Fisher* v. *Commissioner*, 209 F. 2d 513 (C.A. 6), certiorari denied, 347 U.S. 1014; *First Kentucky Co.* v. *Gray*, 309 F. 2d 845 (C.A. 6).

more than an alternative way of expressing the amount to be paid on a particular date. If the note has no fixed due date, it is by far the most convenient form of expression, since the only alternative would be to include a schedule prescribing the exact amount to be paid on each date that the borrower might choose to pay the note. If, however, the note has a fixed due date, and if interest is not to be paid currently, there is little to choose between the two forms of expression: "$100 plus 6% interest" and "$106" mean exactly the same thing and, if anything, the latter has the virtue of greater simplicity. The only difference between the two forms of expression, in short, is that in one case the consideration to be paid for the use of the money is expressed as a formula ($100 times 6%), and in the other case the computation is made in advance and the consideration is expressed as an absolute amount ($6). The difference is that between the expressions "2 times 2" and "4."

Since notes cast in the two forms of expression are in truth identical things, it is perhaps unfortunate that different language has traditionally been used to describe them. A note promising to pay $100 plus 6% interest in one year has traditionally been called an "interest-bearing" note notwithstanding that the stated interest "rate" has no significance beyond prescribing a computation that might as well have been made at the outset. A note, also issued for $100, promising to pay $106 in one year, on the other hand, has traditionally been described as a "non-interest-bearing" note issued at a "discount." In truth, of

course, the note is equally "interest-bearing": the only difference is that the interest is not given a name and is in the form simply of the additional $6 the borrower promises to pay over the amount borrowed. And the statement that the note was issued at a $6 "discount" is but a converse form of the statement that the borrower promised to pay back $6 more than he borrowed. If "interest" by definition is an amount that a borrower agrees to pay a lender in exchange for the use of money—as it is—then "original-issue discount" is by definition interest. For the difference between the face amount of the note and what the lender pays to the borrower ("original-issue discount") is the same thing as the difference between what the borrower receives and what he agrees to repay ("interest").

There is, of course, at least a tangible (if insignificant) distinction between a note under which the interest is to be paid periodically and one under which it is to be paid only on maturity. But that is not the distinction drawn either by the court below or by respondent. Both acknowledge, as they must, that interest is no less interest because paid only on maturity. The distinction they draw is between a note providing for the payment, at maturity, of an amount specifically named "interest" and a note providing for the payment of the same amount at the same time without giving it a name. And between those two things, there is, we submit, no difference at all.

2. Interest is merely "compensation for the use or forebearance of money" (*Deputy* v. *DuPont*, 308 U.S. 488, 498). We do not understand respondent to sug-

gest that a fixed amount, added to the loan, which the borrower promises to pay to the lender is any less compensation for the use of the money than is the same amount when expressed as a percentage. There being nothing in the definition or concept of interest that requires it to be expressed as a percentage, both forms of compensation are equally "interest" and must be taxed as such. If, as respondent concedes, the amount received on a sale of an accrued right to be paid a percentage amount of compensation for the use of money is taxable as ordinary income rather than as capital gain, by the same token the amount received on a sale of an accrued right to be paid a fixed amount of compensation for the use of money is taxable as ordinary income. The only discernible difference is that in one case the compensation is named "interest" by the parties and in the other case is given no name. In a rational tax system nothing can turn on the parties' choice of labels, and the cases of this Court rejecting such distinctions are legion.[7]

The identity of the two forms of compensation from the *borrower's* point of view has long been recognized by the decisions of this and other courts holding that, to the issuer, the inevitable "loss" on redemption of a bond issued at a discount is no less a cost of obtaining the use of money than is stated interest and, hence, that it may be amortized over the life of the loan and be deducted from ordinary in-

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[7] See, *e.g.*, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252.

come. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282; *Old Mission Co.* v. *Helvering,* 293 U.S. 289; *Great Western Power Co.* v. *Commissioner,* 297 U.S. 543; *Western Maryland Ry. Co.* v. *Commissioner,* 33 F. 2d 695 (C.A. 4); *American Smelting & Refining Co.* v. *United States,* 130 F. 2d 883, 885 (C.A. 3). As this Court said in the *Union Pacific* case, the discount at which bonds are issued is but a factor "in arriving at the actual amount of interest paid for the use of capital procured by a bond issue. The difference between the capital realized by the issue and par value, which is to be paid at maturity, must be added to the aggregate coupon payments in order to arrive at the total interest paid" (293 U.S. at 286). As early as 1929, Judge Parker, speaking for the Fourth Circuit, held that original-issue discount "is in reality additional interest payable upon the maturity of the bonds, and a proportionate part of it accrues each year and should be treated as interest paid or accrued on the bonds for that year." *Western Maryland Co.* v. *Commissioner, supra,* 33 F. 2d at 696. And if original-issue discount is to be treated, to the borrower, as a cost of obtaining the use of money, it must be treated, to the lender, as an amount earned by putting his money out to hire—to wit, ordinary income, whether called "interest" or given another name.

The identity of original-issue discount and stated interest from the *lender's* point of view—and the necessity of correlating the treatment of the borrower and the lender—has also been recognized by numerous recent decisions of the lower courts. With the

sole exception of the Sixth Circuit, the lower courts—the First, Second, Third, Fifth and Ninth Circuits, the Court of Claims, and the Tax Court—are uniform in holding that original-issue discount, whether recognized by accrual or realized by a sale or redemption, is taxable as ordinary income to the lender.[8]

Could any doubt remain about the matter, it is answered by the established doctrine that the capital-gains provisions are to be narrowly construed to confine the preferential treatment they afford to transactions plainly within their underlying purpose. *Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 51–52; *Commissioner* v. *Gillette Motor Co.,* 364 U.S. 130; *Commissioner* v. *P. G. Lake, Inc.,* 356 U.S. 260; *Watson* v. *Commissioner,* 345 U.S. 544. A right to promised compensation in a fixed amount for the use of money is no more a "capital asset" than is the constitutional right to just compensation for the temporary use of property by the government (*Gillette*). If land is sold with an unharvested crop, the portion of the proceeds attributable to the unharvested crop is taxable as ordinary income notwithstanding that, as a matter of State law, the crop is deemed a part of the "real estate" until it is severed (*Watson*). If a growing crop of uncertain value is treated as an ordinary-income item, *a fortiori* an accruing right to be paid a fixed sum of money as compensation for the use of money is an ordinary-income item. Nor can the "bunching" rationale invoked by the district court (R. 28–29) justify its result, for there is no dif-

[8] See note 4, *supra*.

ference in that respect between original-issue discount and stated interest which is payable only on maturity, and it is conceded that the latter must be treated as ordinary income.

3. Since original-issue discount and stated interest payable at maturity are identical things, and since the proper treatment of the latter is conceded, it is perhaps unnecessary that we distinguish, from the transaction in this case, other kinds of transactions that involve an element of accretion which, although economically like interest in many respects, is not generally taxed as interest, at least under the existing decisions: whatever it is that distinguishes the accretion element in such cases from stated interest equally distinguishes it from the latter's twin, original-issue discount. In order to make clear the limited scope of the issue before the Court, however, it is appropriate that we note the unique characteristics which stated interest and original-issue discount have in common and which distinguish them both from somewhat similar elements involved in other transactions.

If *A* gives *B* \$100 in exchange for a note promising to pay, in one year, either "\$100 plus 6% interest" or "\$106", it is evident that the additional amount *A* is entitled to receive upon maturity is (1) a specific and readily identifiable amount of money (\$6); (2) an amount of money to be paid *by the borrower* to the lender; and (3) an amount that is agreed to paid solely as an inducement to the lender to give the borrower the use of money under terms admittedly giving rise to a bona fide "indebtedness." As we will

show, those characteristics sharply distinguish transactions involving stated interest or original-issue discount from (a) the purchase of bonds at a "market discount"; (b) the issuance of non-interest-bearing notes in exchange for property other than money; and (c) transactions in which the purported "interest" may represent something other than compensation for the use of money.

a. Market discount.—Assume that a $100, 30-year bond paying $4 interest annually is originally issued at par. Sixteen years later, at a time when, because of a rise in interest rates, comparable bonds are being issued at 5%, the original bondholder sells the bond on the market. Other things being equal, a purchaser would only pay about $90 for the bond, the price at which his receipts from the bond (the annual $4 interest payments plus the $10 "gain" on redemption in 14 years) would give him a 5% yield from his investment.[9] From the *buyer's* point of view, the transaction does not differ significantly from the purchase for $90 of a newly-issued 14-year bond in the face amount of $90 bearing 5% interest or—what amounts to the same thing—in the "face amount" of $100 paying 4% in stated interest and 1% in "original-issue discount" interest. Since the buyer's $10 "gain" on the redemption of the bond is a return from his investment automatically accruing over time, it is economically much like "interest" and perhaps

[9] The current $4 interest payments provide a 5% return on $80 of his investment and the $10 "gain" on redemption provides a 5% return (compounded for 14 years) on the remaining $10 of his investment.

ought to be taxed as such. From the issuing corporation's point of view, however, the transactions are very different, for the only "interest" it is *paying* is the 4% interest it originally contracted to pay when it issued the bond at par. The price at which the bond changes hands on the market in no way affects the issuer or the character, from its point of view, of the payments it has obliged itself to make. The courts, in turn, have traditionally looked only at the character of the payments made by the debtor, and have accordingly not treated "market discount" as giving rise to an "interest" accretion to the purchaser.[10]

Whether it is sound to make the tax treatment of the purchaser turn upon the intrinsic character of the payments made by the issuer—rather than upon the economic significance of the transaction to the particular purchaser—is not a question that need be considered here. The sharply distinguishing characteristic of original-issue discount is that it, like stated interest and unlike market discount, represents an amount paid *by the borrower* for the use of the money: it takes its character as "interest" from the original transaction between borrower and lender, not from some intervening sale of the obligation that arguably changes the character of the receipts in the hands of the particular holder. There is also, of course, a very important pragmatic difference that makes it far more crucial that stated interest and original-issue discount

[10] See *Jaglom* v. *Commissioner*, 303 F. 2d 847, 850–851 (C.A. 2). But see Brandes, *Effect of Discount or Premium*, 19 No. Car. L. Rev. 1, 8–9, 16–17.

be treated as interest to the noteholder than it is that market discount be so treated—to wit, that the borrower is admittedly entitled to deduct stated interest or original-issue discount as a cost of obtaining the use of money, while no one is entitled to deduct the excess of the redemption proceeds over the market price at which a purchaser happens to buy a bond that was originally issued at par.

b. Notes given in exchange for property.—A seller of property will normally insist upon a larger payment for the property if the payment is to be deferred than he would if payment were to be made immediately, and the increase in the amount demanded and paid is in the nature of interest—*i.e.*, compensation for the deferral of payment. Yet if the interest element is not identified as such in the contract or notes, the courts have not generally treated any part of the deferred payments as interest, either for purposes of allowing the buyer an interest deduction or for purposes of taxing part of the payments as ordinary income to the seller.[11] The basic problem in such transactions is that, since the notes are given for property rather than for money, the extent to which the payments constitute interest, even in an economic sense, cannot readily be identified. Findings of the "fair market value" of the property are too uncertain to provide a satisfactory basis for dividing the payments, and the courts have been reluctant, without

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[11] *Paine* v. *Commissioner*, 236 F. 2d 398 (C.A. 8); *MacDonald* v. *Commissioner*, 76 F. 2d 513 (C.A. 2); *Henrietta Mills, Inc.* v. *Commissioner*, 52 F. 2d 931 (C.A. 4); *Kingsford Co.* v. *Commissioner*, 41 T.C. 646.

explicit statutory authority (since supplied [12]), simply to impute a "reasonable" interest rate—*i.e.*, on the assumption that the parties increased the price for deferred payment by the amount of the interest that a reasonable man would have insisted upon as compensation for the deferral in like circumstances.

While the sufficiency of the reasons for not imputing interest in such transactions may be doubted, it is enough for present purposes to note that no such problem of measurement is presented when a note is given in exchange for *money*. In such transactions, whether they are cast in the form of original-issue discount or of stated interest, the additional amount that the borrower agrees to pay in exchange for the use of the money is readily identified as simply the excess of the amount of money the borrower is required to pay back over the amount of money furnished by the lender. The sharp distinction drawn between non-interest-bearing notes issued for money and those issued for property is also established by the fact that the borrower of *money* is allowed a deduction for the "discount" while the buyer of *property* is not.

c. Mislabeled transactions.—It is true, of course, that the form of a promise to pay money does not necessarily determine its economic character or its proper tax treatment. If, for example, *A* agreed to pay *B* 20% "interest" on a loan only because *B* was his son, some part of the payments ought obviously to be

[12] Internal Revenue Code of 1954, § 483, as added by Revenue Act of 1964, § 224, 78 Stat. 19.

treated as a gift notwithstanding the "interest" label. Similarly, under "thin capitalization" principles, instruments in the form of "notes" with stated interest are often treated for tax purposes as actually representing an "equity" rather than a "debt" interest, with the consequence that the purported "interest" payments are treated as non-deductible "dividends."[13] And what is true of notes with stated interest may equally be true of notes issued at a discount. Thus "original-issue discount" does not *necessarily* represent interest on indebtedness any more than stated "interest" does. In either case, an economic analysis of the particular transaction might lead to the conclusion that the promised payment should be characterized as something entirely different from "interest"—*e.g.*, as a gift, as a dividend, as compensation for services, as payment for a capital asset, or as any other kind of payment which taxpayers might choose to cast in the form of "interest" or of "original-issue discount."[14]

Obviously, no such question is presented by this case. The parties dealt at arm's-length, the notes un-

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[13] See Surrey & Warren, *Federal Income Taxation*, pp. 1187–1204 (1960).

[14] It was a question of that sort that was involved in *Lubin* v. *Commissioner*, 335 F. 2d 209 (C.A. 2). The court, although reaffirming its view announced in *Dixon* that original-issue discount must normally be accounted for as interest, held that on the unique facts of that case the excess amount to be paid under the "note" over the sum advanced did not represent interest for the use of the taxpayer's money but rather a participating share in the profits from a joint venture for the purchase of some stock which was believed to have been undervalued by the seller.

questionably represented true indebtedness rather than an equity interest, and the amount agreed to be paid in excess of the amount advanced was admittedly but compensation for the use of the money. Any such question, moreover, would have as much bearing on the treatment of interest labeled as such as it would on the treatment of a payment labeled as "original issue discount," and respondent concedes that the amounts at issue would properly be taxable as ordinary income had they been labeled as "interest" in the notes.

In short, what this case involves, and all it involves, is the treatment of (1) a specific, identifiable, amount of money (2) agreed to be paid by a borrower to a lender (3) as bargained-for consideration for the use of money. The proper treatment of transactions in which one or more of those elements is lacking is not our present concern and need not be considered by the Court.

II

THE AMOUNT PROMISED TO BE PAID ON A NOTE IN EXCESS OF THE AMOUNT FOR WHICH IT WAS ISSUED HAS HISTORICALLY BEEN TREATED AS INTEREST

The courts below do not suggest that a promise to pay a fixed amount, in addition to the amount borrowed, as compensation for the use of the borrowed money (*i.e.*, original-issue discount) can logically be distinguished from a promise to pay the same amount expressed as a percentage of the amount borrowed (stated interest). The ground for the decision below—at least that given by the district court—was rather that the distinction, however illogical, was

firmly settled in the law prior to the 1954 Code and that it would be a "change" in the law for the courts now to reject it. To justify perpetuating an admittedly illogical distinction solely on the grounds of its antiquity would require, at the very least, a far more conclusive showing of a long-continued acceptance of the rule than that made by the district court, even accepting at face value its interpretation of the materials it cites. In fact, however, the history establishes just the opposite. There are, to be sure, the usual number of instances of inconsistency and backtracking to be found in the formative development of a body of law as intricate as the tax system. But the basic character of original-issue discount as interest in another form was recognized at an early date and whatever inconsistencies there may have been in its treatment were resolved long prior to the 1954 Code. The recent decisions of the other courts treating the proceeds of a sale of a note attributable to original-issue discount as ordinary income were thus evolutionary rather than revolutionary; they merely recognized the unavoidable implications, in the sale context, of the long-recognized identity of "original-issue discount" and "interest."

The decision below was based largely on an earlier decision of the same court. As our discussion of that case will show, it was not until after 1953 that it was first squarely held that the proceeds of a sale of a bond *with stated interest* could be allocated in part to the interest earned up to date of sale and the part so allocated be taxed as ordinary income. Since there were

no pre-1954 cases so holding as to stated interest, it is not surprising that there were none so holding as to original-issue discount. To determine whether there was an established *distinction* between the two forms of interest, therefore, it is necessary to examine other contexts in which the distinction might have been important; deductibility of the payments by the borrower; application of the tax exemption accorded to "interest" on tax-exempt bonds; and accruability of income by accrual-basis taxpayers. In none of those contexts, we will show, did such a distinction ever become established. Since stated interest and original-issue discount were treated alike in every other context, it was inevitable that, once it was recognized that a bond with accrued interest was not a unitary "capital asset" and that the portion of the proceeds of its sale attributable to the accrued interest might be taxed differently from the portion attributable to the underlying asset, the rule would be, as it has been, applied equally to both forms of interest.

1. The courts below relied primarily on the Sixth Circuit's own prior decision, in 1944, in *Commissioner v. Caulkins,* 144 F. 2d 482. Since the Commissioner originally acquiesced in that decision [15] and did not announce his change of position until 1953,[16] it is

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[15] 1944 Cum. Bull. 5.

[16] Rev. Rul. 119, 1953-2 Cum. Bul. 95, limited the acquiescence in *Caulkins* "precisely to what was there decided under the particular facts of that case." In 1955, the acquiescence was withdrawn in its entirety, except as to taxpayers who had purchased the particular Accumulative Investment Certificates involved in *Caulkins* prior to withdrawal of the acquiescence. Rev. Rul. 55-136, 1955-1 Cum. Bull. 7, 213, republished as Rev. Rul. 56-299, 1956-1 Cum. Bull. 603.

important to note precisely what that case held and what its true status is today. We will show that the decision made no distinction between original-issue discount and stated interest but was rather based on a ground that has since been repudiated even by the Sixth Circuit itself and which even respondent acknowledges can no longer be maintained.

The taxpayer in *Caulkins* purchased from a corporation an "Accumulative Installment Certificate" under which he made ten annual payments totaling approximately \$15,000 and then surrendered the certificate for a payment of \$20,000, an amount representing a cumulative return on his investment of 5½%, which figure was in turn printed on the face of the certificate.[17] The court held that the \$5,000 gain was taxable as capital gain under § 117(f) of the 1939 Code, which provided that:

> * * * amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidence of indebtedness issued by any corporation * * *, with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

The court based its decision, not upon a distinction between original-issue discount and stated interest, but solely upon its reading of § 117(f) as specifically directing that *all* amounts received upon the retirement of such a certificate, whether representing interest or not, be accounted for as the proceeds of a sale or exchange of a capital asset—*i.e.,* as capital

[17] Query: Was that "stated interest" or "original-issue discount"?

gain or loss. The court expressly agreed that the $5,000 increment, identical to interest compounded at 5½% for the period, was "consideration paid for the use of the amounts paid in" and thus "interest" as defined by this Court in *Deputy* v. *Dupont, supra,* and acknowledged that it was "difficult to perceive any practical reason for taxing increment of the type involved here differently from ordinary income" (p. 484). Yet the $20,000 was plainly an "amount received on retirement of the certificate" and, since the court read § 117(f) as specifically providing that "amounts received on retirement of the securities listed should be calculated as capital gain or capital loss" (ibid.), it concluded that it made no difference that a part of proceeds represented interest. What the court held, in short, was not that original-issue discount was different from stated interest, but that § 117(f) did not permit of any apportionment of the "amounts received * * * upon the retirement" of certificates of indebtedness and required that the proceeds be treated as a unitary amount received in exchange for a capital asset.

To the extent that the decision treated § 117(f) as itself authorizing capital gains treatment—which, on its face, is what the decision did—it was plainly mistaken. The basic definition of capital gains, not cited by the court, was § 117(a)(4), which defined capital gain as "gain from the sale or exchange of a capital asset." All that § 117(f) did was to satisfy the "sale or exchange" requirement, thereby overcoming the prior rulings that a retirement or redemp-

tion of a security was not a sale or exchange.[18] Whether the thing in "exchange" for which the proceeds were received was a "capital asset"—in whole or only in part—was a quite separate question, and it seems plain that that question was not meant to be answered differently in the case of a retirement than in the case of an actual "sale or exchange."

It is perhaps possible, although the opinion in no way suggests it, that the court assumed that a debt obligation with accrued interest would, on a *sale*, be treated as a single indivisible "capital asset." If that were so, instead of making the obvious error of reading § 117(f) as intended to accord preferential treatment to retirements rather than merely put them on a par with sales and exchanges, the court would have made a somewhat more subtle but even more fundamental error. A "capital asset" is defined in § 117(a)(1) simply as "property", and in property-law terms a right to receive the interest earned on a debt obligation may well be regarded, not as an independent property right separate from the obligation itself (at least until it is severed), but simply as one of the incidents of ownership of the underlying obligation. It would therefore have required no more than the common but fundamental error of assuming that property-law concepts are controlling for capital-gains purposes[19] for the court to have made the mistake of assuming that a debt obligation with accrued interest was one indivisible thing the whole of which must be treated as a "capital asset."

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[18] See *Fairbanks* v. *United States*, 306 U.S. 436.

[19] An error which this Court has many times been required to point out. *E.g.*, *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Palmer* v. *Bender*, 287 U.S. 551.

But whether based on an attribution to § 117(f) of a specific purpose to give capital-gain treatment to all retirement proceeds regardless of the treatment of sales (the apparent holding) or on an unstated assumption that a debt obligation is a single indivisible "capital asset" for all purposes, *Caulkins* has been wholly repudiated by later cases the soundness of which is not challenged even by respondent. In 1953, this Court held that, notwithstanding that for property-law purposes an unharvested crop is treated as a part of the "real estate" until it is severed, land with a growing crop is not for tax purposes a unitary "capital asset" and that the portion of the proceeds of its sale allocable to the unharvested crop (in proportion to its value) must be separately accounted for as ordinary income. *Watson* v. *Commissioner,* 345 U.S. 544. And in 1954, the Sixth Circuit itself held that, on the sale of a bond with accrued interest, the portion of the proceeds attributable to the interest earned up to the date of the sale must be separately accounted for and taxed as ordinary income, thus becoming the first court of appeals squarely to so hold. *Fisher* v. *Commissioner,* 209 F. 2d 513. Other courts have uniformly agreed,[20] also recognizing, after some hesitation, that whatever is true of sales must also be true of retirements inasmuch as the only purpose of § 117(f) was to equate retirements with sales.[21] Because of those decisions—and the compelling anal-

[20] See note 2, *supra.*

[21] The cases involving stated interest (note 2, supra) were all cases of sales rather than retirements, but the cases involving original-issue discount involved both sales and retirements

ogy of this Court's decision in *Watson* v. *Commissioner*—it is now universally regarded as settled, if there were ever room for doubt, that on either the sale or redemption of a debt obligation the portion of the proceeds attributable to the interest earned to the date of the sale is taxable as ordinary income.

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and ultimately rejected any distinction between the two forms of disposition.

The Tax Court initially adhered to the distinction between sales and redemptions suggested by the *Caulkins* case, holding that the interest element was separately taxable in the case of a sale (*Paine* v. *Commissioner*, 23 T.C. 391, 401, reversed on other grounds, 236 F. 2d 398 (C.A. 8); *Shattuck* v. *Commissioner*, 25 T.C. 416, 423; *Stanton* v. *Commissioner*, 34 T.C. 1, 6) but that in the case of a *redemption* § 117(f) required all the proceeds, without allocation, to be accounted for only as capital gain or loss (*Goodstein* v. *Commissioner*, 30 T.C. 1178, 1193, affirmed on other issues, 267 F. 2d 127 (C.A. 1); *Morgan* v. *Commissioner*, 30 T.C. 881, reversed, 272 F. 2d 936 (C.A. 9); *Kormendy* v. *Commissioner*, decided April 15, 1959 (P-H Tax Ct. Mem. Dec. ¶ 59,072); see also *Rosen* v. *United States*, 185 F. Supp. 805 (W.D. Pa.), reversed, 288 F. 2d 658 (C.A. 3); *Wood* v. *United States*, decided November 15, 1960 (6 A.F.T.R. 2d 5991), reversed *sub nom. United States* v. *Harrison*, 304 F. 2d 835 (C.A. 5), certiorari denied, 372 U.S. 934). Later, however, the Tax Court expressly rejected the distinction and thereafter held the interest element to be separately taxable on either a sale or a redemption. *Gibbons* v. *Commissioner*, 37 T.C. 569 (redemption); *Schwartz* v. *Commissioner*, 40 T.C. 191 (redemption); *Lubin* v. *Commissioner*, decided October 24, 1963 (P-H Tax Ct. Mem. Dec. ¶ 63,292), reversed on other grounds, 335 F. 2d 209 (C.A. 2) (redemption); *Oglansky* v. *Commissioner*, decided January 23, 1963 (P-H Tax Ct. Mem. Dec. ¶ 63,018) (sale).

The courts of appeals from the outset rejected the *Caulkins* distinction between sales and redemptions and uniformly held the interest element separately taxable in either case. Redemptions: *Commissioner* v. *Morgan*, 272 F. 2d 936 (C.A. 9); *Rosen* v. *United States*, 288 F. 2d 658 (C.A. 3); *United States* v. *Harrison*,

Those later cases, it may be seen, fully exposed the basic error of the decision in *Caulkins*. And once it was acknowledged that proceeds of sale attributable to accrued stated interest were taxable as ordinary income, it followed automatically—as all the courts, with the sole exception of the Sixth Circuit, have held—that the same rule applied to interest in the form of a promise to pay a fixed, rather than a percentage, amount (*i.e.*, "original-issue discount"). *Caulkins* itself had drawn no distinction between the two forms of interest and, since no rational distinction can be drawn, the repudiation of the premise of *Caulkins* had precisely the same implication for both forms of interest. In short, neither *Caulkins* nor the Commissioner's subsequently withdrawn acquiescence were concerned with a distinction between stated interest and original-issue discount, and the reliance of the courts below on the decision and acquiescence to establish such a distinction was wholly misplaced.

2. Since it was not until after 1953 that the divisibility of the proceeds of a sale of debt obligation between principal and interest was put beyond doubt, the inquiry whether, before that time, interest in the form of original-issue discount was treated differently from stated interest must, as we have noted, look to

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304 F. 2d 835 (C.A. 5), certiorari denied, 372 U.S. 934; see also *Lubin* v. *Commissioner*, 335 F. 2d 209 (C.A. 2). Sales (in addition to those cited in note 2, *supra*): *Pattiz* v. *United States*, 311 F. 2d 947 (Ct. Cls.); *Real Estate Investment Trust of America* v. *Commissioner*, 334 F. 2d 986 (C.A. 1), pending on petition for certiorari, No. 620; *Dixon* v. *United States*, 333 F. 2d 1016, pending on certiorari, No. 486.

other contexts in which the nature of an item as "interest" is relevant. One such context is the treatment of the *borrower* and his right to deduct amounts he is required to pay in exchange for the use of borrowed money. If the interest is payable currently, there is no question of its deductibility either by an accrual-basis or a cash-basis taxpayer. If the interest is labeled as such but is payable only on maturity, there is likewise no question of the right of an accrual-basis taxpayer to accrue and deduct each year the portion of the interest allocable to that period of time. The question, then, is whether original-issue discount was treated any differently, and the answer is that it was not.

The regulations under the 1939 Code, in a provision dating back to 1918,[22] expressly provided that "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds." Regs. 118, § 39.22(a)–17(c). As early as 1929, the Fourth Circuit sustained that treatment on the specific ground that original-issue discount "is in reality additional interest payable upon the maturity of the bonds, and a proportionate part of it accrues each year and should be treated as interest paid or accrued on the bonds for that year." *Western Maryland Ry. Co. v. Commissioner*, 33 F. 2d 695, 696. That view, as we have pointed out above (pp. 14–15, *supra*), was

[22] Treas. Regs. 33, Art. 150 (1918 ed.). The exact language quoted in the text was first adopted in Treas. Regs. 45, Art. 544(3)(a) (1920 ed.).

later endorsed by this Court, and since then there has been no doubt about the matter.

3. Another area in which the character of an item as interest is important is in the application of the exemption from the income tax accorded to "interest" from State and municipal bonds (§ 22(b)(4) of the 1939 Code; § 103 of the 1954 Code). By 1920, it was established that, if the original holder of a State bond held it to maturity and was then paid by the State an amount in excess of the price at which the bond was issued, the excess represented interest paid by the State and was therefore exempt from any tax.[23] At the same time, however, the Bureau ruled that on *sales* of exempt bonds no part of the gain—whether attributable to stated interest *or* to original-issue discount—was exempt from tax, giving as its reason that "no person other than the municipality can pay the interest borne by the obligations of the municipality (whether such interest is paid at a specified rate or in the form of realized discount)."[24] That ruling again treated "rate" interest and "discount" interest as the same, ruling only that the exemption of the interest when paid did not extend to the proceeds of a sale of the *right* to the interest. Up to that point the rulings followed an understandable, if perhaps formalistic, pattern. More obscure are the reasons for a ruling issued in 1927 holding that the interest element of the

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[23] O.D. 647, 3 Cum. Bull. 123 (1920); O.D. 737, 3 Cum. Bull. 49 (1920). A contrary ruling issued in 1919 (O.D. 238, 1 Cum. Bull. 68) was revoked.

[24] O.D. 737, 3 Cum. Bull. 49 (1920); see also O.D. 762, 4 Cum. Bull. 31 (1921).

amount paid by a State in redemption of a bond issued at a discount was exempt only if paid to the original purchaser of the bond, and was not exempt if paid to a subsequent holder.[25] It is unnecessary to speculate about the rationale of that distinction,[26] for it was in any event short-lived.

In 1929, Congress by statute exempted the "interest" on Treasury bills from taxation and provided that "the amount of discount at which Treasury bills are originally sold by the United States shall be considered to be interest within the meaning of this subdivision." Act of June 17, 1929, 46 Stat. 19, 20. In their report on the bill, the House managers made plain that it was intended not only to exempt the increment realized by the original purchaser on redemption (the Bureau's position on State bonds) but also to exempt the portion of the proceeds realized by each successive holder attributable to the "interest" earned during his period of holding.[27] Thus Congress not only

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[25] G.C.M. 1455, VI-1 Cum. Bull. 87 (1927).

[26] Since the ruling reaffirmed the exemption of the increment when paid to the original holder, it in no way impaired the basic principle that original-issue discount was in its nature "interest." Indeed, there is nothing to indicate that the ruling would not have been applied equally to stated interest payable only at maturity.

[27] The report stated (H. Conf. Rep. No. 17, 71st Cong., 1st Sess., p. 2):

> Under the present law, when tax-exempt securities are sold at a discount in lieu of interest, any increase in value realized by the original purchaser is tax exempt; but no exemption is granted a subsequent holder. In order to prevent the application of this rule, the Senate amendment provides for the computation of interest at the original discount rate for the period during which the security is

agreed with the Bureau that original-issue discount was a form of interest but carried that principle to what seemed to it the logical conclusion—a proration of the exemption among all the successive holders.[28]

Although the 1929 Act applied only to Treasury bills, and not to State bonds, the Bureau accepted generally the underlying principle of the Act that, if the interest itself is exempt, so too should be the proceeds of a sale of the right to the interest earned

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held, whether by the original purchaser or any subsequent holder. In other words, the original discount rate at which the security is sold is substituted for the interest rate fixed by the security itself in the case of an interest-bearing obligation. The amount of tax-exempt interest is apportioned among the holders according to the period of their holdings. Any gain in excess of this amount is taxable and any loss resulting from a sale or other disposition is allowed as a deduction.

The Treasury Decision implementing the Act adopted the treatment indicated by the report. T.D. 4276, VIII–2 Cum. Bull. 83 (1929).

[28] In the debates on the bill there was basic agreement by everyone that original-issue discount was in its nature interest and that any realized accretions in value attributable to the discount should therefore be wholly exempt from tax; the only dispute was over the need for a special provision and over the language that would best accomplish that result without also exempting gains attributable instead to fluctuations in the market value of the security. See 71 Cong. Rec. 2328–2333. How the gains would be taxed to the extent they were not exempt (*i.e.*, as ordinary income or as capital gain) was not as such the subject matter of the discussion. In any event, it is entirely possible that at that early date it was assumed that *any* gain on a sale of a bond would be taxable as capital gain, whether attributable to stated interest *or* to discount. There were many concepts of the tax law that were not developed by 1929, and it would be no surprise if the severability of an accrued income item from the underlying asset were one of them.

up to the date of the sale. Accordingly, in 1932 the Bureau revised its rulings on *State and municipal* bonds to afford the same treatment to original-issue discount on such bonds that Congress had prescribed for Treasury bills—*i.e.,* exempting from tax any amounts received by any holder that were attributable to the original-issue discount prorated over his period of holding.[29] The ruling was reaffirmed in 1940[30] and there the matter has since stood. In short, but for some uncertainties during the 1920's as to the proper application of the principle, which in turn were resolved at least by 1932, original-issue discount on State and municipal bonds has consistently been treated as interest for purposes of the statutory exclusion of "interest" from such bonds.

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[29] G.C.M. 10452, XI-1 Cum. Bull. 18 (1932); see also G.C.M. 13320, XIII-2 Cum. Bull. 138 (1934).

[30] G.C.M. 21890, 1940-1 Cum. Bull. 85, summarized the ruling position as follows:

> The amount of discount received at maturity on Treasury bills (T.D. 4276, C.B. VIII-2, 83 (1929)), on noninterest-bearing State bonds (G.C.M. 10452, C.B. XI-1, 18 (1932)), and on interest-bearing municipal obligations (I.T. 2629, C.B. XI-1, 20 (1932)) is held to be nontaxable income, and each purchaser of the bond before maturity is entitled to apportion the amount of discount at which the obligation was issued according to the period of his holding. The earned discount in the present case is, therefore, nontaxable income to the taxpayer.
>
> The courts have considered the nature of discount in cases involving private corporations and have held it to be in the "nature of deferred interest" which may be amortized, for income tax purposes, over the life of the bonds by deducting the annual proportion thereof from the issuing corporation's gross income each year as "accrued interest."

See also I.T. 3486, 1941-2 Cum. Bull. 76.

4. A final question to which the character of an item as "interest" is important is whether a lender who reports on the accrual basis must accrue the item as income as it is earned or may defer accounting until it is realized. In 1920, the Bureau ruled that original-issue discount on corporate bonds was not accruable as income by the holder notwithstanding that it was accruable as a deduction by the issuer.[31] The reason, though unclear, may have been simply the pragmatic one that, with the bonds frequently changing hands, it would impose an undue burden to require each holder to ascertain the original discount and account for it, a problem not encountered

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[31] O.D. 475, 2 Cum. Bull. 211 (1920). O. 1024, 2 Cum. Bull. 189 (1920), also issued in the same year and the only ruling cited by the district court (R. 23–24), does not seem to us in point. The statute involved taxed nonresident foreign corporations only on "interest, rents, salaries * * * or other fixed or determinable, annual or periodic * * * income" from sources within the United States. The ruling held that income from buying and selling bank acceptances issued at a discount was not taxable under that provision. Although acknowledging that discount "is compensation for the use of money and as such resembles interest", it made the distinction that interest, unlike discount, "is payable annually or at shorter periods before maturity of the obligation." In view of the limitation of the statute to "annual or periodic" types of income, the distinction made seems to us a permissible one for purposes of that statute. But cf. I.T. 3889, 1941-1 Cum. Bull. 79. In any event, the distinction made by the courts below and by respondent is not that between currently payable interest and interest payable only on maturity but rather one between amounts payable at maturity which are called interest and those which are given no name.

by the issuer.[32] In 1922 and 1923, however, it was ruled that the annual increase in the redemption price of redeemable certificates, although not taxable to a cash-basis taxpayer until actual redemption, had to be accrued as "interest" by an accrual-basis taxpayer.[33] More significant was the ruling in 1925 requiring a bank lending money on discounted notes (*e.g.,* making a loan of $100 in exchange for the borrower's note for $106 payable in a year) to accrue the income earned each year, explaining that: "Bank discount is the compensation charged by the bank for the use of its money, and hence is earned in the same way as interest—by lapse of time. It follows that under the accrual system such discount is income to the bank as it is earned." [34] The ruling also expressly distinguished market discount (*i.e.,* the difference between the price at which the bank purchased interest-bearing notes on the market and their face amount, see pp. 18–20, *supra*) which it held need not be accrued.

In the same year that the ruling last cited was issued, the Board of Tax Appeals likewise held that a bank must accrue its income from discounted notes. *Chatham S. Phenix National Bank* v. *Commissioner,* 1 B.T.A. 460. Two years later, the Board held that a bank could not amortize the difference between the face amount of bonds and securities held in its port-

[32] That may also have been the explanation for the distinction once drawn between the original purchaser and subsequent holders of State bonds. See pp. 33–34, *supra.*

[33] T.D. 3301, I–1 Cum. Bull. 100 (1922) (United States savings certificates); I.T. 1684, II–1 Cum. Bull. 60 (1923) (similar instruments issued by a bank).

[34] S.M. 3820, IV–2 Cum. Bull. 32 (1925).

folio of investments and the price it had paid for them. *Corn Exchange Bank* v. *Commissioner,* 6 B.T.A. 158. Whether any of the securities had been originally issued at a discount is not indicated in the opinion and, whatever the fact may have been, the failure of the Board to focus on the distinction between market discount and original-issue discount makes the decision little authority on the treatment of the latter. In any event, in later years the Board has repeatedly reaffirmed its holding in the *Phenix National Bank* case that a bank must accrue income from discounted notes,[35] thus consistently recognizing that original-issue discount is but another form of interest.

In 1935, the Bureau again affirmed its view of original issue discount as a form of interest, ruling that accrual-basis taxpayers must accrue the annual increment in value attributable to the discount at which United States savings bonds were issued.[36] While the statute authorizing the bonds specifically provided that the discount "shall be considered as interest," the ruling relied, not on that provision, but on the 1925 ruling requiring banks to accrue discounts on loans (S.M. 3820, note 34, *supra*), noting that the "situation is analogous to that where a noninterest-bearing loan is made at a discount which is included in the face amount of the note."

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[35] *Chicago Acceptance Co.* v. *Commissioner*, 12 B.T.A. 150, 152 (1928); *Vancoh Realty Co.* v. *Commissioner*, 33 B.T.A. 918 (1936); *Motors Securities Co., Inc.* v. *Commissioner*, decided October 30, 1952 (P-H Tax Ct. Mem. Dec., ¶ 52,316).

[36] G.C.M. 15875, XIV-2 Cum. Bull. 100 (1935).

By 1941,[37] Congress regarded it as settled not only that original-issue discount must be accrued by an accrual-basis taxpayer but, indeed, that the proceeds of a sale attributable to the discount were taxable as ordinary income rather than capital gain. By the Public Debt Act of February 19, 1941, 55 Stat. 7, 9, Congress had repealed the exemption of Treasury bills from taxation, providing that the interest on such obligations "shall not have any exemption, as such, and loss from the sale or other disposition of such obligations shall not have any special treatment, as such, under Federal tax Acts now or hereafter enacted."[38] Later that year, in considering the bill that became the Revenue Act of 1941, the Finance Committee took note of the consequence of the repeal of the exemption and the resulting applicability to Treasury bills of the normal rules of accounting (S. Rep. No. 673, Part 1, 77th Cong., 1st Sess., pp. 30–31):

> The requirements of existing law with respect to Treasury bills issued on or after March 1, 1941 [the effective date of the Public Debt Act], impose on taxpayers the duty of making burdensome computations. The portion of the gain attributable to the original discount on such bills is considered as interest and the remainder is treated as a capital gain. Thus, where such a bill is sold by the original holder for an amount in excess of the purchase price

[37] For a contemporaneous analysis demonstrating the treatment of original-issue discount as interest for purposes both of accural accounting and tax exemption, see Brandis, *Effect of Bond Discount or Premium*, 19 No. Car. L. Rev. 1 (1940).

[38] Despite that express language, a ruling issued on the treatment of Treasury bills shortly after the withdrawal of the

plus the issuing discount accrued to the date of sale, allocation to interest and capital gain is required. In the case of a loss resulting from the sale of such a Treasury bill, the loss is treated as a capital loss and must be segregated as such. Being a short-term capital loss, it is allowable only to the extent of short-term capital gains. Moreover, the existing rule that the original discount on Treasury bills accrues ratably over the entire life of the bills requires each successive taxpayer holding a particular bill to ascertain the amount of such discount

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exemption relied on the fact that the 1929 exemption statute (quoted at p. 34, *supra*) had expressly provided that the discount at which Treasury bills were issued "shall be considered to be interest." I.T. 3486, 1941-2 Cum. Bull. 76. But the 1929 Act had provided only that the discount should be considered as interest "within the meaning of this subdivision"—*i.e.*, for purposes of the exemption—and that provision could thus not of its own force control the treatment of Treasury bills after Congress not only withdrew the exemption but denied to such bills any "special treatment" at all. The significance of the 1929 provision, that is, derived not from its force as a statutory command (no longer operative) but from its recognition of the underlying *principle* that discount is in fact but another form of interest, a principle that the Bureau in 1941 quite properly carried forward to the treatment of Treasury bills after the exemption was repealed just as it had in 1932 carried it over to the treatment of State bonds (see pp. 35-36, *supra*). Moreover, the committee report quoted in the text, while expressing the same view as to the proper treatment of Treasury bills under existing law, in no way implied that the treatment was the product of some specific statutory command rather than of the application of general principles—indeed, the provision being reported was not limited to Treasury bills but applied also to State bonds to which the 1929 provision had never applied. Finally, as noted below (note 40), the Senate committee report on the 1954 Code relied on I.T. 3486 as evidence of the general principles being applied, not as a ruling peculiar to Treasury bills.

which is treated as accruing during the period for which he held the bill.

In the case of short-term obligations—where gains or losses not attributable to the discount were unlikely to be significant and the time of accounting made little difference—it was obvious that such precise accounting did not make enough difference to warrant the burden of making it. The Committee accordingly recommended, and Congress enacted, two new provisions of the 1939 Code dealing expressly with all governmental obligations (State as well as federal) issued at a discount with a term not exceeding one year: § 117(a)(1)(D), excluding such obligations from the definition of a "capital asset"; and § 42(c), providing that "the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold or otherwise disposed of." Revenue Act of 1941, § 115, 55 Stat. 687, 698. The result was to defer all accounting until final disposition of the obligation and to require that the entire gain then be treated as ordinary income. As to all private obligations and all long-term government obligations, however, Congress obviously intended the "existing law"—requiring, in its view, that the proceeds attributable to the discount and those attributable to market fluctuations be separately accounted for, the former as ordinary income and the latter as capital gain or loss—should continue to apply.[39]

[39] Examples of the application of §§ 42(c) and 117(a)(1)(D), in contrast with the rules otherwise applicable, are given in Regs. 118, § 39.117(a)-1(d), *infra*, p. ~~48~~. 51.

In the same Act, Congress also added § 42(b) to the 1939 Code (*infra*, p. 47), applicable to any "noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals," including private as well as governmental obligations. If "the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his income) constitute income to [the taxpayer] in such year," the statute allows the taxpayer to elect to include it in income. The committee reports explained that under existing law an accrual-basis taxpayer was required to accrue the annual increase but a cash-basis taxpayer had to report the entire increase in value all in the year of redemption; the purpose was to give cash-basis taxpayers an option to report the increases annually. H. Rep. No. 1040, 77th Cong., 1st Sess., pp. 40–41; S. Rep. No. 673, Part 1, 77th Cong., 1st Sess., p. 29. In that provision also, therefore, Congress acted on the premise that, under existing law, accrual-basis taxpayers were required to accrue original-issue discount.[40]

In sum, not only is original-issue discount logically indistinguishable from stated interest (as shown in

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[40] Unfortunately, what Congress regarded as settled in 1941 became unsettled by the Sixth Circuit's decision in *Caulkins* in 1944 (*supra*, pp. 25–31). To overcome that decision, Congress adopted a new provision in the 1954 Code (§ 1232) expressly making any gain on sale or redemption of an obligation taxable as ordinary income to the extent of any original issue discount. Although reaffirming once again the long-standing view of Congress that original-issue discount "is a form of interest income" and noting the settled law that discount "is deductible as an interest

Point I), but it has from an early date been treated as interest for purposes of deductibility by the borrower, application of the exemption of "interest" on State bonds, and accrual accounting. In the Revenue Act of 1941, moreover, Congress not only recognized that it was treated as interest under existing law but, acting on that assumption, expressly excepted short-term governmental obligations from the rules otherwise applicable to obligations issued at a discount. Far from requiring that an admittedly illogical distinction be perpetuated (as the district court thought),

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payment" by the issuer, the reports reflected the confusion created by *Caulkins* as to the treatment of the gain to the holder. H. Rep. No. 1337, 83d Cong., 2d Sess., p. 83; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 112. The House committee report was undiscriminating, stating that under "existing law" any gain from either a retirement or a ~~redemption~~ sale of a bond was treated as a capital gain even though in fact a part of it represented original-issue discount, "a form of interest income." Since *Caulkins* had been based specifically on the redemption provision (§ 117(f)), and no case had so held as to sales, the committee's comments on the existing law (hardly approving in any event) were at the very least overbroad. The Senate committee was more precise, noting that under "section 117(f) of present law" there is "some uncertainty" as to the treatment of the proceeds of *retirement* of a bond issued at a discount, citing I.T. 3486, 1941-2 Cum. Bull. 76 (see note 38, *supra*) "as compared with" *Caulkins*. The main significance of the 1954 reports, we submit, is that both committees recognized that original-issue discount in fact is "a form of interest income," that it has always been deductible as "interest" by the issuer, and that it plainly ought to be taxed as ordinary income to the holder. The committees disagreed about what the existing "law" or "uncertainty" was—with the Senate committee correctly noting that the uncertainty created by *Caulkins* went only to the treatment of retirements under § 117(f)—but they both agreed that the result reached by *Caulkins* was wrong in principle and that the proper treatment should be made clear for the future.

the history of the treatment of original-issue discount confirms what is obvious: that bargained-for compensation for the use of borrowed money is interest, and must be taxed as such, by whatever name the parties choose to call it.

CONCLUSION

For the reasons stated, the judgment below should be reversed.

Respectfully submitted.

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APPENDIX

A. Internal Revenue Code of 1939 and Regulations 118.

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived * * * from interest, * * * or gains or profits and income derived from any source whatever. * * *

* * * * *

Sec. 41. General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayers; * * *.

Sec. 42. Period in Which Items of Gross Income Included.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(b) *Noninterest-bearing Obligations Issued at Discount.*—If, in the case of a taxpayer owning any noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (d), the increase in the redemption price

of such obligation occurring in the taxable year does not (under the method of accounting used in computing his net income) constitute income to him in such year, such taxpayer may, at his election made in his return for any taxable year beginning after December 31, 1940, treat such increase as income received in such taxable year. * * *

(c) *Short-term Obligations Issued on Discount Basis.*—In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of.

(d) *Matured United States Savings Bonds.*—In the case of a taxpayer who—

(1) holds a series E United States savings bond at the date of maturity, and

(2) pursuant to regulations prescribed under the Second Liberty Bond Act retains his investment in the maturity value of such series E bond in an obligation, other than a current income obligation, which matures not more than ten years from the date of maturity of such series E bond,

the increase in redemption value (to the extent not previously includible in gross income) in excess of the amount paid for such series E bond shall be includible in gross income in the taxable year in which the obligation is finally redeemed or in the taxable year of final maturity, whichever is earlier. The provisions of this subsection shall not ap-

ply to a corporation, and shall not apply in the case of any taxable year for which the taxpayer's net income is computed upon the basis of the accrual method of accounting or for which an election made by the taxpayer under subsection (b) is applicable.

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer * * * but does not include—

* * * * *

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, * * *.

* * * * *

(f) *Retirement of Bonds, Etc.*—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

* * * * *

U.S. Treasury Regulations 118 (1939 Code):

§ 39.22(a)-17 *Sale and purchase by corporation of its bonds.* * * * (c) If bonds are issued

by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

* * * * *

§ 39.42–7 *Short-term obligations issued on discount basis.* In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of. Accordingly, if a taxpayer who computes his net income on the accrual basis purchases upon issuance a United States Treasury bill and holds it until maturity, the entire amount of the discount at which the bill was originally sold accrues on the date of maturity; and if such a taxpayer holds a United States Treasury bill for a period less than its life, the portion of the original discount attributable to such period accrues only on the date on which he sells or otherwise disposes of the bill or receives payment at maturity. The original discount or the portion of such discount, as the case may be, is includible only in the gross income for the taxable year in which the taxpayer sells or otherwise disposes of the bill or receives payment at maturity. For examples illustrating rules for computation of income from sale or other disposition of obligations of the type described in this section, see § 39.117(a)–1.

* * * * *

§ 39.117(a)-1 *Meaning of terms.*

* * * * *

(d) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term "capital assets." * * * It is, therefore, not necessary for a taxpayer, other than a life insurance company subject to taxation only on interest, dividends, and rents, to segregate the original discount accrued (see § 39.42-7) and the gain or loss realized upon the sale or other disposition of any such obligation.

Example (1). A (not a life insurance company) buys a $100,000 90-day Treasury bill upon issuance for $99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for $99,999.50. The entire net gain to A of $1.50 may be taken into account as a single item of income, without allocating $1 to interest and $0.50 to gain. If B holds the bill until maturity his net gain of $0.50 may similarly be taken into account as a single item of income, without allocating $1 to interest and $0.50 to loss.

Example (2). The facts in this example are the same as in example (1) except that the selling price to B is $99,998.50. The net gain to A of $0.50 may be taken into account without allocating $1 to interest and $0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of $1.50 may be taken into account as a single item of income without allocating $1 to interest and $0.50 to gain.

* * * * *

B. Internal Revenue Code of 1954

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

Sec. 1232. Bonds and Other Evidences of Indebtedness.

(a) *General Rule.*—For purposes of this subtitle, in the case of bonds, debentures, notes or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) *Retirement.*—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) *Sale or exchange.*—

(A) [As amended by Sec. 50(a), Technical Amendments Act of 1958, P.L. 85–866, 72 Stat. 1606] *General rule.*—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

* * * * *

(ii) * * * an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity,

shall be considered as gain from the sale or exchange of property which is not a capital

asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

* * * * *

(b) *Definitions.—*

(1) *Original issue discount.*—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. * * *

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